No. 15076.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RANDALL FOUNDATION, INC.,

Appellant,

vs.

ROBERT A. RIDDELL, Director of Internal Revenue, District of Los Angeles,

Appellee.

BRIEF FOR THE APPELLANT.

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Jurisdiction.

This is an appeal from a judgment of the United States District Court of the Southern District of California, Central Division, dismissing with prejudice petitioner's (Appellant herein) complaint against Robert A. Riddell, Director of Internal Revenue, District of Los Angeles, to recover overpayment of Federal income tax for its fiscal years ended April 30, 1951 and April 30, 1952.

Appellant is a duly incorporated, non-profit California corporation, whose principal place of business is at Los Angeles, California. Its application for exemption from Federal income tax under Section 101(6) of the 1939 Internal Revenue Code was duly filed but was rejected by the Commissioner of Internal Revenue. Appellant thereafter filed income tax returns for its fiscal years ended April 30, 1951 and April 30, 1952, paid the taxes shown thereby in the amount of $6,677.13 and $14,113.24, respectively, and filed claim for refund in accordance with the provisions of Section 3772 of the 1939 Internal Revenue Code. Defendant (Appellee herein) failed to act on said claim or to refund or credit any portion of the taxes paid. Appellant brought this action in the United States District Court for the Southern District of California, for recovery of the taxes paid in accordance with the provisions of the Internal Revenue Code and the jurisdiction conferred on said court by Title 28, U. S. C., Section 1340 and Section 1346.

This court has jurisdiction on this appeal under Title 28, U. S. C., Section 1291 and Section 1294.

Statement of the Facts.

The facts in this case are not in dispute. The principal facts are stipulated [R. 44 through 104], and the evidence submitted at the trial consisted of uncontroverted testimony explaining and clarifying these stipulated facts [R. 125, *et seq.*]. These facts, insofar as they are relevant to this appeal, are as follows:

Appellant was incorporated on or about May 11, 1950, and has ever since existed, as a non-profit California corporation under those portions of the California Corporations Code known as the General Non-Profit Corporation Law [R. 45, 54, 116].

Its entire assets are irrevocably dedicated to charitable purposes and under no circumstances can they inure to the benefit of its founder or other private person. Its Articles specifically provided:

> "That the specific and primary purpose for which said corporation is formed is to aid, assist, contribute to and/or establish charitable, religious and educational institutions, organizations and foundations.
>
> * * * * * * * *

"That the Trustees hereunder shall have equal voting power but no individual property rights in or to any assets of the foundation or corporation.

*   *   *   *   *   *   *   *

"No member shall have any proprietary interest whatever in or to any of the assets of the corporation, and no income, increments, or other pecuniary gain, benefit, or advantage of any kind, in any way arising from or growing out of the assets of the corporation or their operation will inure to or in any way go to or vest in any member of the corporation. Upon the dissolution or winding up of the corporation, after paying or adequately providing for the debts and obligations of the corporation, and remaining assets shall be distributed to a religious, educational or charitable organization located in California and selected by the Board of Trustees."

Appellant was organized for the primary purpose of establishing a home for underprivileged boys without regard to race, creed or color [R. 21, 131, 161, 164]. Appellant's original articles stated only general charitable purposes, rather than the specific primary purpose for which it was organized. This was done on the basis of legal advice that it was unnecessary to state Appellant's specific charitable purposes [R. 164]. Subsequently the articles were amended to provide that Appellant's primary purpose is to establish a home for underprivileged boys, without regard to race, creed or color [R. 21]. At approximately the same time, the By-Laws were amended to provide that Appellant must either commence construction of a boys' home by December 31, 1957 or establish facilities for the actual residence of at least fifty boys by not later than December 31, 1959. Under California law such a provision must be in the By-Laws rather than the Articles [R. 21, 62, 164, 166].

It was estimated that an initial capital of $250,000 would be required to set up this home and that, with the combined contributions of Mr. Randall, other members of the Board, and outside persons, together with accumulated profits from Appellant's investments, it would take from two to four years to accumulate this fund [R. 150, 168]. During the three or four years preceding organization of the Randall Foundation, Mr. Randall contributed approximately 10% of his annual income to charitable organizations [R. 131]. He intended to contribute at least 10% of his income to Appellant each year after its organization and contributed securities of a fair market value of $20,752.11 during its first fiscal year [R. 131, 48, 116]. The Internal Revenue Service denied Appellant's application for exemption September 12, 1951. As a result of this denial, contributions thereafter were nominal [R. 48, 157]. During the first fiscal year Mr. Randall loaned Appellant $155,200 at an interest rate of 2½% per annum [R. 48, 49, 116], which with its other assets, it used in the purchase of securities.

Upon the organization of the foundation, Mr. Randall became its president and was delegated broad authority over the investment of its assets [R. 67, 71, 76]. He thereafter devoted a portion of his abilities to the skilled management of Appellant's investment portfolio. When he saw an opportunity to buy at a favorable price he would cause the foundation to do so. Similarly, he would cause it to sell whenever he saw that the funds could be more profitably invested elsewhere [R. 8, 51]. Such purchases and sales were made frequently.

Neither Mr. Randall nor Appellant is, nor at any time has been, a broker or dealer in securities. All purchases and sales were made through brokers who purchased or sold for Appellant either on a listed exchange or on the over-the-counter market. Neither Appellant nor Mr. Randall knew the party from whom or to whom purchases and sales were made. No compensation was paid to Mr. Randall for his services and the only profits to any other person through these transactions were the normal brokerage fees paid to the brokers handling the sales and purchases [R. 117, 132]. Neither Mr. Randall nor any other person made any profit, directly or indirectly, from Appellant's activity.

The income, expenses, and gains from disposition and sale of securities of plaintiff for its three fiscal years ended April 30, 1951; April 30, 1952, and April 30, 1953, were as follows:

	Year Ended		
	4/30/51	4/30/52	4/30/53
Dividends and interest	$10,285.00	$ 7,081.93	$2,937.67
Expenses	1,532.36	8,271.99	5,966.03
Gains from disposition and sale of securities	30,238.27	51,079.61	5,456.01

Thus, during its first fiscal year ended April 30, 1951, Appellant accumulated, through gifts, dividends and interest, and gains on securities, approximately one-quarter of the capital which it was estimated would be required to establish the boys' home. This progress accorded with the original estimate of two to four years beore construction of the home for under-privileged boys could be begun [R. 150, 168].

During this period Mr. Randall examined properties in several areas of the state which might be purchased for the construction of the home [R. 138]. Inspection of properties continued during the second fiscal year despite the notification *on September 12, 1951* that Appellant's application for tax exemption had been denied [R. 138, 139]. Following April 30, 1952 Appellant employed Mr.

Ramsdell, a former employee of the Los Angeles City School System, to assist in investigating prospective properties on behalf of the foundation. During this period Mr. Ramsdell and Mr. Randall also made a trip to Omaha, Nebraska, to visit and study in detail the operation of Father Flanagan's Boys Home [R. 139, 140].

In addition to these activities, Appellant made gifts to other recognized charitable organizations as follows:

Date	Organization	Amount
4/24/51	Children's Hospital Society of L. A.	$ 500.00
5/26/51	Sister Elizabeth Kenny Foundation	100.00
7/22/51	St. John's Hospital	1,000.00
8/31/51	Montecito School for Girls	2,000.00
4/30/52	David Seabury School of Psychology	2,000.00
4/30/52	Bureau of Welfare, California Teachers' Association	1,000.00
4/30/52	American Red Cross	1,000.00
4/30/52	Y.M.C.A. of South Pasadena	1,000.00
4/30/52	All Nations Foundation	1,000.00
4/30/52	Children's Hospital of Los Angeles	500.00
4/30/52	Montecito Schools, Inc.	500.00
4/30/52	Girl Scouts of South Pasadena	100.00
4/30/52	Cate School	1,000.00
	Total	$11,700.00

(It will be noted that in accordance with its primary purpose of establishing a home for under-privileged boys, Appellant made only relatively small contributions to other charitable organizations until after its own application for exemption was denied.)

Appellant filed its application for exemption from Federal income tax under Section 101(6) of the Internal Revenue Code shortly after the close of its first fiscal year on April 30, 1951. Formal notice that exemption was rejected was received September 12, 1951 [R. 45, 118].

Appellant thereafter continued its efforts to secure exemption since it realized that failure to do so would delay establishment of the boys' home by preventing donations and increasing expenses by reason of the taxes payable on its other income. These efforts were unsuccessful and on June 10, 1953 income tax returns for the fiscal years ended April 30, 1951 and April 30, 1952 were filed and taxes in the amount of $6,677.13 and $14,113.24, respectively, were paid. Claims for refund were filed for both years on June 12, 1953 [R. 46]. True and correct copies of these claims and a memorandum submitted in support thereof are set forth in the record at pages 24 through 34. Said claims were not acted upon by the Bureau and this action was instituted for refund of the taxes paid. The trial court refused the refund and this appeal followed.

Issue Involved.

The issue involved in this appeal is whether Appellant was exempt from Federal income taxation for the fiscal years ended April 30, 1951 and April 30, 1952 under Section 101(6) of the Internal Revenue Code of 1939, which reads as follows:

> "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. <u>For loss of exemption under certain circumstances see sections 3813 and 3814.</u>" (Underlined portion was added by the Revenue Act of 1950 and is applicable only to the fiscal year ended April 30, 1952.)

The meaning of the quoted section is affected by other explicit statutory provisions, such as Sections 302(a) and 301(b) of the Revenue Act of 1950. Said sections are quoted and discussed hereafter.

Specification of Errors.

The Appellant assigns as error the following:

Findings of Fact:

1. That plaintiff was not organized or operated exclusively for a charitable purpose during the fiscal years ended April 30, 1951 and April 30, 1952 within the meaning of Section 101(6) of the 1939 Internal Revenue Code [XI].

2. That plaintiff was operated during the fiscal years April 30, 1951 and April 30, 1952 for the primary purpose of carrying on a trade or busines for profit [XII].

3. That trading in securities and receiving dividends were plaintiff's only activities during its first year of existence [V].

4. That no charitable activity was directly carried on by the plaintiff during its second fiscal year [VI].

Conclusions of Law:

5. That plaintiff was not organized and operated exclusively for a charitable purpose during the fiscal years ending April 30, 1951 and April 30, 1952 within the meaning of Section 101(6) of the 1939 Internal Revenue Code [II].

6. That plaintiff is not entitled to exemption from Federal income taxation with respect to the fiscal years ended April 30, 1951 and April 30, 1952 under Section 101(6) of the 1939 Internal Revenue Code [III].

7. That plaintiff is not exempt from Federal income taxation for the fiscal year ended April 30, 1951 under the provisions of Section 302(a) of the Revenue Act of 1950 [IV].

8. That plaintiff is within Section 301(b) of the Revenue Act of 1950 and hence not exempt from Federal income taxation for the fiscal year ended April 30, 1952 [V].

9. The rulings of the Comissioner of Internal Revenue that plaintiff was not entitled to exemption from taxation for the fiscal years ended April 30, 1951 and April 30, 1952 were not erroneous [VI].

10. That plaintiff was operated during the fiscal years ending April 30, 1951 and April 30, 1952 for the primary purpose of carrying on a trade or business for profit [VII].

11. The defendant is entitled to judgment against the plaintiff dismissing the complaint herein with prejudice, and for his costs [IX].

The findings of fact set forth in 3 and 4, *supra,* are plainly incorrect in that they overlook the uncontroverted testimony that Appellant inspected properties throughout the state in an attempt to find and purchase land suitable for the boys' home which Appellant planned to build and operate [R. 138]. This is certainly both an "activity" and a "charitable activity." With this exception the issues on this appeal involve only the application of rules of law to undisputed facts. Appellant therefore objects not only to the correctness of the conclusions of law reached, but to specifications 1 and 2, *supra,* being denominated as findings of fact.

Summary of Argument.

1. Appellant was organized for charitable purposes.

2. Appellant was operated for charitable purposes in two different ways, each of which is sufficient for purposes of the claimed exemption:

(a) Appellant examined proposed sites for its boys' home and was engaged in accumulating the funds necessary for the establishment of such home.

(b) Appellant made substantial gifts of its assets to recognized charitable organizations.

3. The aforesaid charitable purpose of Appellant's organization and operation constituted the exclusive purpose thereof notwithstanding its activity in purchasing and selling securities. Such activity did not prevent Appellant's qualifying for exemption for the following reasons:

(a) For Appellant's fiscal year ended April 30, 1951, the statute, Section 302(a) of the Revenue Act of 1950, specifically provides that exemption cannot be denied because of such activity.

(b) For the year ending April 30, 1951, Appellant's stock market activity, even ignoring for the moment the specific exemption of Section 302(a) of the Revenue Act of 1950, was not of such a nature as to warrant denial of exemption, for the following reasons, which reasons also distinguish the instant case from the recent decisions of this Circuit in *Ralph H. Eaton v. Commissioner* (9th Cir., 1955), 219 F. 2d 527, and *John Danz Charitable Trust v. Commissioner* (9th Cir., 1955), ... F. 2d ......, 55-2 U. S. T. C. par. 9723.

(i) Such stock market activity was merely ancillary to Appellant's charitable purpose and could not by its very nature constitute an independent purpose for Appellant's existence or operations.

(ii) The purpose of Appellant's stock market activity was not to raise funds to feed other charities but was intended as the means to assist in raising the necessary funds for Appellant to establish and operate its own charity—a home for under-privileged boys.

(iii) Appellant's stock market activity did not and could not constitute a *competitive* business such as was involved in the *Eaton, Danz* and *Community Service* cases referred to herein. Thus, the reasons of policy which dictate that competitive businesses should not be operated tax-free to the prejudice of their taxable competitors, which were involved in the cases just cited, do not apply to the instant case.

(c) For the year ending April 30, 1952, Appellant's stock market activity was not of such a nature as to warrant denial of exemption for the following reasons:

(i) The reasons summarized under (b) above with respect to the year ended April 30, 1951, are equally applicable to the year ended April 30, 1952.

(ii) The Revenue Act of 1950 extensively revised the statutory provision covering the taxability of charitable organizations. These revisions are applicable to Appellant's year ending April 30, 1952, and provide additional confirmation that Appellant is exempt under Section 101(6) of the Internal Revenue Code of 1939 for said year.

ARGUMENT.

I.

Appellant Was Organized for Charitable Purposes.

Appellant was organized as a non-profit corporation under those portions of the California Corporation Code known as the General Non-Profit Corporation Law [R. 45, 54, 116]. Its original Articles clearly stated that it was organized for charitable purposes [R. 16]. The amended Articles specify that the primary purpose is to establish a home for under-privileged boys, without regard to race, creed or color [R. 21]. Its assets are irrevocably dedicated to these purposes and cannot, under any circumstances, accrue to the benefit of its founder or other private person [R. 18]. This is so as a matter of law. The California Supreme Court has held that Articles which are far less clear than Appellant's dedicated the entire property forever to the charitable purposes stated therein:

> *In re L. A. County Pioneer Society* (1950), 40 Cal. 2d 852, 257 P. 2d 1.

Furthermore, the undisputed testimony of three witnesses is that Appellant was organized for the primary purpose of building and operating a home for under-privileged boys [R. 131, 161, 164].

There can be no question on the basis of these uncontroverted facts that Appellant was organized for charitable purposes within the meaning of Section 101(6).

> *Sico Co. v. United States* (Ct. Cl. 1952), 102 Fed. Supp. 197;
>
> *Sand Springs Home* (1927), 6 B. T. A. 198;
>
> *Jack Little Foundation For Aid to the Deaf v. Jones* (W. D. Okla. 1951), 102 Fed. Supp. 326.

II.

Appellant Was Operated for Charitable Purposes.

Appellant's activities confirmed that it was operated for the purposes for which organized. Its primary purpose was to build and operate a home for under-privileged boys. All reasonable steps were taken toward this end:

(1) Properties throughout the State were inspected during both fiscal years in question in an attempt to find a suitable location for the boys' home at a suitable price. These activities continued subsequent to April 30, 1952, and, in addition, Mr. Randall and Mr. Ramsdell visited and made a detailed inspection of Father Flanagan's Boys Home [R. 138-140].

(2) Appellant diligently attempted to supplement its income from contributions and thus hasten the day when the boys' home could be built by investing its funds in securities selected by Mr. Randall and actively selling and reinvesting whenever this profitably could be done.

Raising monies to be used for charitable purposes is just as necessary and just as much a charitable activity as spending them. Necessarily, when a charitable organization is working toward a future objective, such as building a boys' home, its charitable activities will be predominantly in raising money rather than in spending it until the required initial capital can be accumulated.

Appellant's principal purpose of building and operating a home for under-privileged boys was, by its very nature, a project which would require a large initial investment. It would indeed be a sad commentary on the law if such projects were limited to foundations created by the very wealthy who could immediately endow them with sufficient funds to make such a large initial expenditure.

Only a very few cases have considered the propriety of accumulating funds for future projects. Those which have, involved accumulations far less worthy and far more extreme than the one here, yet have unqualifiedly rejected any rule against accumulation.

> *William T. Bruckner, et al., Trustee* (1930), 20 B. T. A. 419.
>
> In this case the Will made gifts to Godair Memorial Old Peoples Homes which was incorporated as a nonprofit corporation in 1919. "The Trustees from time to time made investigations of the cost of maintenance of such a home and in regard to the various types of buildings to be erected for the purpose of the Home, and decided that a two-story building should be erected, plans for which had been drawn. The erection was, at the time of trial, expected to commence in the spring of 1930." The Trustees under the decedent's Will claimed deductions from its income for the years 1919 to 1923 for income set aside for such corporation. In holding that the trust was entitled to the deduction for the income thus permanently set aside for such corporation, the Tax Court said:
>
> > "Its conservation during a wise consideration of how best to fulfill the charitable purpose is not at variance with the clear legislative pur-

pose of the deduction, and the statute should not be so narrowly read as to exclude situations so plainly within its beneficent intendment. * * * Clearly a corporation is operated for charitable purposes within the meaning of this statute when it actively sells some of its property in order to invest it more suitably for the charitable purpose of its creation and also employs an architect and otherwise engages in preliminary research to carry forward its main project of building and maintaining a charitable home."

William T. Buckner, et al., Trustee (1930), 20 B. T. A. 419, 423.

Ohio Furnace Company, Inc. (1955), 25 T. C. number 27, at p. 11:

"Remaining is the question whether the use by the Foundation of substantially all of its income for making the investment in Furnace Company stock, as contrasted with immediate and direct application thereof to the Shattuck School or other comparable schools, makes the operation of the Foundation other than an operation exclusively for educational purposes within the meaning of section 101(6). The only reference in the statute bearing specifically upon the use of income is the prohibition that no part of the net earnings of the corporation, fund or foundation may inure to the benefit of any private shareholder or individual. Conversely, it is reasonable to conclude, we think, that the requirements of 101(6) are satisfied if all of the income inures to the benefit of, or is in promotion of, an operation which is exclusively educational. *Certainly there is no requirement that the income must either be used or distributed in the year realized for the described purpose, and we know of no case wherein a corporation, fund, or foundation was denied exempt status* *merely because it accumulated its income for distribution in a succeeding or later year.*" (Emphasis added.)

Schoellkoff v. United States (2nd Cir. 1942), 124 F. 2d 982.

(A trust which was to accumulate its income for *one hundred years* for charitable purposes was held to be one organized and operated exclusively for the requisite charitable purposes.)

In *Hanover Improvement Society v. Gagne* (1st Cir., 1937), 92 F. 2d 888, a corporation organized for civic improvement purposes operated a theater building under lease as a source of income, and a portion of this income was accumulated for the purpose of purchasing a new theater building. The company was held exempt as a civic league not organized for profit "but operated exclusively for the promotion of social welfare."

Even if we assume that the accumulation must be a reasonable one, something which the existing cases do not require, there can be no question that Appellant's accumulation was reasonable. It was originally estimated that two to four years accumulation would be required. Almost 25% of the required capital was accumulated during Appellant's first fiscal year. Even with contributions cut off by the adverse ruling on Appellant's exemption an additional 20% was added in the second year [R. 52, 150, 168]. There can thus be no question that the two to four year estimate was reasonably accurate, and that the accumulation called for was reasonable.

Appellant submits that, when a concrete and realistically obtainable objective is chosen and all reasonable steps are taken towards its consummation, exemption cannot be denied because the nature of the project prevents large-scale charitable activities during the fund raising period.

In addition to the above activities, which in themselves are clearly sufficient to meet the statutory requirement, it will be noted that during the years here in question taxpayer also contributed to acknowledged and qualified charitable institutions gifts totaling $11,700.00. Such contributions in themselves constitute a sufficient charitable activity to qualify the donor for exemption. This has been an accepted principle for so long that no case has been found in which it has even been questioned. The answer undoubtedly lies in the fact that in 1924 the Bureau of Internal Revenue itself ruled that:

> "A corporation formed to dispense charity which does not actually engage in charitable undertakings itself but distributes its income to institutions organized and operated exclusively for the purposes of subdivision (6) of Section 231 is exempt from taxation under said section."
>
> I. T. 1945, III-1, C. B. 273 (1924).

From the above it is clear that Appellant was at all times operated for charitable purposes in conformity with its charter which as a matter of law required such an operation. Thus, the only question remaining is whether or not the frequency of Appellant's purchases and sales in the stock market could operate to deny Appellant the exemption to which it is otherwise clearly entitled.

III.

Appellant's Otherwise Exempt Status Is in No Way Affected by the Frequency of Its Purchases and Sales of Securities.

Fiscal Year Ended April 30, 1951

A. Even Assuming for the Moment, Contrary to the Arguments Set Forth in Sub-section (b) Hereafter, That Appellant's Purchases and Sales of Securities Constituted the Carrying on of a Trade or Business for Profit, Section 302(a) of the Revenue Act of 1950 Specifically Prohibits the Denial of Exemption Because of Such Activity.

Section 302(a) of the Revenue Act of 1950 provides:

> "Sec. 302. Exemption of Certain Organizations For Past Years.
>
> (a) Trade or Business Not Unrelated.—For any taxable year beginning prior to January 1, 1951, no organization shall be denied exemption under paragraph (1), (6), or (7) of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property)."

In short, for a taxable year beginning prior to January 1, 1951, an organization cannot be denied exemption on the ground that it was carrying on a trade or business for a profit unless it had unrelated business income taxable under Supplement U.

There is no suggestion that Appellant had any unrelated business income as defined in Supplement U for its fiscal year ended April 30, 1951. Nor could such a suggestion be made since all of Appellant's income fell into one of the categories specifically exempted from the definition of unrelated business income by Section 422(a)(1) and (5) of the I. R. C. of 1939:

> "There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.
>
> "There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business."

Moreover, under Section 422(b)(1), Appellant cannot even be considered as being in an unrelated trade or business since (even assuming, contrary to the above, that it did have unrelated business income) the statute excludes from its definition of an unrelated trade or business any trade or business:

> "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation."

The only possible remaining question is whether Appellant was denied exemption on the ground that it was carrying on a trade or business for profit.

As will be discussed at length hereinafter, Appellant submits that it was not carrying on a trade or business for profit. But, there can be no question that this was the ground on which its exemption was denied by the Court below.

Finding of Fact XII [R. 121] and Conclusion of Law VII [R. 122] state that plaintiff was operated for the primary purpose of carrying on a trade or business for profit. Finding of Fact XI [R. 121] and Conclusion of Law II [R. 121] state that plaintiff was not organized and operated *exclusively* for charitable purposes. It is undisputed that Appellant was organized for charitable purposes [R. 21, 131, 161, 164] and that it engaged in charitable activities [R. 51, 117, 119, 138 through 140]. There can, therefore, be no question that Appellant was denied exemption on the ground that it was operated primarily to conduct a trade or business for profit, and hence was not organized and operated exclusively for charitable purposes. *This is precisely the ground on which Section 302(a) forbids exemption being denied.*

Appellant respectfully submits that the determination of the Court below that Section 302(a) does not prevent denial of Appellant's exemption for the fiscal year ended April 30, 1951, is unquestionably erroneous.

B. Even Ignoring for the Moment the Specific Exemption of Section 302(a) Discussed Above, Appellant's Stock Market Activity Was Not of Such a Nature as to Warrant Denial of Exemption.

No informed person would ever suggest that an exempt organization must limit its fund raising activities to the solicitation of contributions. It is now much too common to see schools, churches and other accepted charities raising funds through paper drives, dinners, bazaars and assorted other activities which are in no way related to their charitable purposes except to provide funds. Perhaps such activities should be taxed, as many now are under Supplement U, but they should not be the basis of denying general exemption to the organization.

Investment in stocks and bonds for both current income and appreciation is a particularly well accepted source of income for many exempt organizations. It is well known that many colleges today derive most of their income from their investments and utilize the talents of businessmen and stock market analysts to manage actively their investment portfolios. Some have only a relatively light turn-over in investments, but many, like Appellant, have the benefit of top grade investment advice and actively buy and sell.

We submit that on principle there is no reason for basing tax exemption on the number of purchases and sales taking place within a particular year. Such activity may be expanded or contracted as the needs of the charitable purposes demand. Thus, it is always ancillary to such purposes.

It is well known that certain types of businesses tend to become ends or purposes in themselves. An automobile agency or spaghetti factory requires the hiring of employees, building of a business organization, buying equipment, obtaining customers and a variety of other activities. The business cannot expand and contract depending on whether its founders are accumulating funds for a future project or currently spending them. It is by its nature permanent in form and endowed with needs and demands of its own. The needs of a charitable beneficiary will generally be subordinate to the demands of the business. This is not so with the purchase of securities. By its nature, it is an investment activity where excess funds can be invested or withdrawn so as to conform to the ultimate charitable purpose.

The fundamental nature of such activity is not changed by the volume of purchases and sales made. This is recognized in the cases establishing that, regardless of volume of sales, all gains from sales of securities for one's own account are taxable as capital gains.

> *Pacific Affiliates, Inc.,* 18 T. C. 1175 at 1212 (1952), Acq. C. B. 1953-19, 1.
>
> *George R. Kemon* (1951), 16 T. C. 1026.

This is true because such gains result from a change in value of the securities rather than a mark-up for services performed. The Tax Court has clearly explained this difference in the nature of a dealer's and trader's profit as follows:

> "Those who sell 'to customers' are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. *Cf. Schafer v. Helvering, supra; Securities-Allied Corp. v. Commissioner,* 95 F. 2d 384, certiorari denied, 305 U. S. 617, affirming 36 B. T. A. 168, *Commissioner v. Charavay,* 79 F. 2d 406, affirming 29 B. T. A. 1255. Such sellers are known as 'dealers.'
>
> "Contrasted to 'dealers' are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up

> of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as 'traders.' "

This view is confirmed by the Supreme Court's decision in *Higgins v. Commissioner* (1940), 312 U. S. 211, 61 Sup. Ct. 475, holding that an individual investor was not engaged in a trade or business for income tax purposes even though he had engaged in numerous transactions throughout the taxable period.

It should be noted in both the *Eaton* (9th Cir. 1955) 219 F. 2d 527, and *Danz* (9th Cir. 1955) 55-2 U. S. T. C. Par. 9723, cases that the organizations involved were engaged in businesses which as explained above would develop ends and purposes in themselves and thus could not be ancillary to the ultimate charitable purpose of the organization. A second difference between the instant case and the facts involved in the *Eaton* and *Danz* cases lies in the permanent feeder nature of the organizations there involved. The circumstances before the Court in each such case have been the same: a feeder organization, organized and operated to run commercial enterprises having their own independent needs and demands and never intended itself to engage in charitable activities. Its only claim to exemption was that its profits must eventually be given to charitable organizations.

These cases emphasize that the organization had no intention of engaging itself in charitable activities:

> "Clearly, however, the corporation itself was not intended to operate and did not operate as a religious, educational or charitable institution. What was proposed was only that the profits from its various busi-

ness activities would be turned over to such institutions."

Ralph H. Eaton Foundation v. Commissioner of Internal Revenue (9th Cir., 1955), 219 F. 2d 527.

In sharp contrast with this situation is the fact that Appellant is itself a charitable organization and not merely a feeder. Its amended Articles [R. 21] and By-Laws [R. 62] supported by the uncontroverted testimony of Mr. Randall [R. 121], Dr. Bailes (a minister of religion and one of the original Trustees) [R. 161], and Mr. Flanagan (one of the original Trustees and the attorney who drew the Articles) [R. 164], show beyond any doubt that Appellant was organized for the specific and primary purpose of building and operating *itself* a home for under-privileged boys.

Appellant could, under its Articles, also make gifts to other charitable organizations. It did so, particularly after its own exemption was denied. Such gifts undoubtedly provide additional confirmation that Appellant was organized and operated for charitable and not business purposes. But, they were temporary in nature and are not the primary basis for its exemption. They are completely incidental to its stated primary purpose of building and operating itself a home for under-privileged boys. Gifts to other charities by an organization which is itself organized and operated for charitable purposes does not convert it into a feeder organization in any sense of the term.

A third important difference between the instant case and the facts involved in the *Eaton* and *Danz* cases is that the organizations there involved were operating commercial enterprises in competition with tax-paying businesses. In the *Eaton* case, this Court relied upon and referred to the Fourth Circuit's decision in the *Community Services* case, *United States v. Community Services* (4th Cir., 1951), 189 F. 2d 421. In that case, the Fourth Circuit stressed such competitive nature of the business involved at page 425 stating:

> "Manifestly, a corporation engaged in commercial activities, if exempt from federal taxes, would have a tremendous economic advantage over competitors in the same field. Such a corporation could effectively eliminate competitors, actual and potential, since it could undersell corporations, whose earnings are subject to diminution by federal taxation. It is difficult to believe that Congress intended to countenance such a situation."

Appellee must concede that Appellant was not a dealer in securities. It did not maintain a business organization, nor an inventory of securities for sale to customers. All it did was buy and sell securities for its own account from or to unknown principals, and collect the dividends thereon.

Its activity is passive in nature, and it competes for no one's customers. As stated by the Senate Finance Committee in its Report No. 2375, 81st Congress, 2nd Session, 1950 C. B. page 483 at 505, in explaining why the 1950 Revenue Act excluded capital gains from unrelated business income:

> "Your Committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts."

To summarize, it is respectfully submitted that neither the holding nor dicta of the *Eaton* and *Danz* cases is applicable to the instant case for the three reasons above explained:

(1) Appellant's market activity was passive and ancillary to its ultimate charitable purpose, whereas the activity involved in the cases referred to was of such a nature that it developed its own ends and purposes and could not be merely ancillary to a charitable purpose.

(2) Appellant is a charitable organization organized and operated to accomplish its own charitable purpose, whereas the organizations involved in the cases referred to never intended to engage in charitable activity but were merely intended to feed their income or profits to other charities.

(3) Appellant in its stock market activity did not compete with anyone, whereas the organizations involved in the cases referred to engaged in commercial enterprises which competed for the customers of tax-paying businesses.

Because of these three differences, it is respectfully submitted that Appellant's otherwise exempt status should not be denied because of its activities in which it bought and sold securities. Thus, Appellant is clearly entitled to exemption for its year ended April 30, 1951, wholly aside from the clear and independent exemption afforded it by Section 302(a) of the Revenue Act of 1950.

Fiscal Year Ended April 30, 1952

C(1) For Its Fiscal Year Ended April 30, 1952, Appellant's Otherwise Exempt Status Is Not Affected by the Frequency of Its Purchases and Sales of Securities for the Reasons Summarized Under Section III-B Above, Which Are Equally Applicable to the Year Ended April 30, 1952.

As previously noted, prior to the Revenue Act of 1950 the only statutory provisions applicable to Appellant's exemption was Internal Revenue Code Section 101(6). This section was retained unchanged by the Revenue Act of 1950, except for the addition of the last sentence thereto quoted below, and provides for exemption of:

> "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or invidual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances see sections 3813 and 3814."

The discussion above in subsection B setting forth the reasons why Section 101(6) could not reasonably be construed to deny exemption to Appellant for its fiscal year ended April 30, 1951, is equally applicable to its subsequent fiscal years. However, it is even more persuasive in 1952 because confirmed by the detailed provisions added by the Revenue Act of 1950.

C(2) The Revenue Act of 1950 Extensively Revised the Statutory Provision Covering the Taxability of Charitable Organizations. These Revisions Are Applicable to Appellant's Year Ending April 30, 1952, and Provide Additional Confirmation That Appellant Is Exempt Under Section 101(6) of the Internal Revenue Code of 1939 for Said Year.

The statutory provisions governing exemption were completely revised by the Revenue Act of 1950. The wording of Section 101(6) quoted in Section III C(1) above was not changed but detailed explanatory provisions were added to Section 101(6) and other portions of Section 101 to define the conditions under which exemptions would be lost in whole or part. Due to their length, Appellant has not attempted to set out the complete text of the 1950 Amendments, but has attached abstracts of relevant portions in Appendix A.

I. R. C. Section 3813 denies exemption if an organization engages in any of the list of prohibited transactions set forth therein. Appellee must concede that Appellant did not engage in any prohibited transactions.

I. R. C. Section 3814 denies exemption in certain cases of unreasonable accumulation of income. As has already been discussed in detail, Appellant planned to accumulate income for from two to four years. This is clearly not an unreasonable accumulation within the meaning of Section 3814 or any other definition of unreasonable accumulations. If there is any doubt on this point it is clearly dispelled by consideration of the legislative history of this provision of the 1950 Revenue Act. The final language making the exemption dependent upon an "unreasonable accumulation" was considered to be more liberal for the charitable organizations involved than the original provisions of the House Bill which had set specific test as to how much of an accumulation could be permitted. However, the House Bill permitted a specific exception for an accumulation of funds for five years or less for a specific purpose, explaining the reasons for said exception in the following language:

> "Your committee believes such an exception is desirable in order to permit an organization to commit its income over several years for a specific project which cannot be financed out of one year's income or which cannot be put into operation immediately."
>
> *H. R. Report No. 2319, 81st Congress, Second Session,* 1950 C. B. 380 at 411.

Supplement U levies a tax on the unrelated business income in excess of $1,000 of certain specified exempt organizations. I. R. C. Section 422(b) specifically excludes from the definition of an unrelated trade or business any trade or business in which substantially all of the work in carrying on the business is performed without compensation. Section 422(a) excludes income from dividends, interest and capital gains from the definition of unrelated business income. Either of these subsections is in itself clearly sufficient to prevent taxation of Appellant under Supplement U.

Section 101 of the 1939 Internal Revenue Code was amended to incorporate by reference the tests of Sections 3813, 3814 and Supplement U. There was also added to it a new paragraph as follows, which prevented feeder organizations from qualifying for exemption:

> "An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph

the term 'trade or business' shall not include the rental by an organization of its real property (including personal property leased with the real property)."

The court below determined as Conclusion of Law Number V [R. 122] that Appellant is within the feeder organization amendment and hence not exempt. Appellant submits that this Conclusion is clearly erroneous for the following reasons:

(1) The above provision only applies to an organization which claims exemption solely on the ground that all of its profits are payable to another exempt organization. Appellant claims exemption because of its own charitable purposes and activities and is therefore not affected by said section. Stated in another way, the use of the word "payable," rather than the word "paid" in the above provision, indicates a situation where such profits must be paid to other charitable organizations. Such is not the case with appellant since the only contributions it made to other charities were purely of its own volition. In other words, if the Appellant had been *required* to pay its profits to other charities it might fall within the above quoted language but, since this is not the case, the above language does not apply to Appellant.

(2) Wholly aside from the above reasons the above section does not apply because Appellant was not carrying on any "trade or business for profit" within the meaning of that phrase as used in said section. An examination of the 1950 Committee Reports confirms this construction. Both the House and Senate Reports use the manufacture of automobiles to illustrate the type of trade or business referred to. The cases cited in the Reports give, by implication, additional illustrations such as the

manufacture of spaghetti. These illustrations leave little doubt that the phrase "operation of a trade or business for profit" refers to the operation of a commercial enterprise furnishing products or services to customers and competing for customers. There is not the remotest suggestion that an activity such as the purchase and sale of securities for one's own account should be included.

(3) A third reason why the feeder provision is not applicable to Appellant is that the "primary purpose" of its organization was not the purchase and sale of securities but the establishment and operation of a home for under-privileged boys.

The discussion above clearly shows that Appellant was neither taxable nor declared non-exempt under any of the detailed provisions of the 1950 Revenue Act. The only remaining question is whether it could conceivably still not be exempt.

Prior to the Revenue Act of 1950, exemption had been challenged in a number of cases on the ground that the organization was operated for business purposes and hence not exclusively for charitable purposes as required by the statute.

In each case the government contended that exemption should be denied because:

> (1) The organization was deriving business income in no way related to its charitable purposes by the active conduct of a commercial enterprise; and
>
> (2) This was its only activity except to pay its profits over to recognized charitable organizations.

In almost every case the government lost—*i.e.,* the court declared that Section 101(6) allowed exemption regardless of these factors. This court can properly take judicial notice that the 1950 Act was passed as a result of the criticism leveled against these decisions. The 1950 Amendment specifically provided that:

> (1) An organization operated primarily to carry on a business for profit which claimed exemption solely on the ground of its gifts to other exempt organizations, should no longer be exempt.
>
> (2) Even though an organization did not lose its exemption under (1) it would be taxable on any unrelated business income as defined in Supplement U.

It need scarcely be added it was assumed that if an organization was neither non-exempt under (1) nor taxable on unrelated business income under (2), it would not lose its exemption under Section 101(6) by reason of its so-called business activities.

This is made very clear by the Senate Committee Report to Section 302(a). It will be recalled that Section 302(a) provides that for years prior to the effective date of the 1950 Act, organizations shall not be denied exemption on the ground that they are carrying on a trade or business for a profit unless they had unrelated business income as defined in Supplement U. The Committee Report comments:

> "This is to assure that no more strict rule will be applied for such years than will be applied in the future under the bill."
>
> Senate Committee Report No. 2375, p. 118.

It would be difficult to imagine a clearer expression of Congressional intent that for years after the effective date of the Act no organization could be denied exemption on the ground that it was carrying on a trade or business for profit unless it had unrelated business income as defined in Supplement U.

Conclusion.

After this case had been submitted in the lower court, this Circuit decided the case of *Ralph H. Eaton Foundation v. Commissioner* (9th Cir. 1955), 219 F. 2d 527. That decision upon its promulgation was immediately submitted to the lower court, and undoubtedly had a most important influence on its decision against Appellant. In this brief we have demonstrated the many differences existing in the *Eaton* case and the instant facts which, we submit, would require that the instant case be decided differently from the *Eaton* case even if both had involved the same statutory provisions. However, the vital difference is that the *Eaton* case, as well as the *Danz* case hereinabove referred to, involved years prior to 1950 which were not affected in any way by the elaborate changes in the statute bearing on the instant question which were made by the Revenue Act of 1950.

We have demonstrated that the change applicable to Appellant's year ended April 30, 1951, embodied in Section 302(a) of the Revenue Act of 1950, clearly and explicitly states the intention of Congress that an organization such as Appellant should be exempt. Furthermore, the quotations from the applicable Committee Reports discussed in Part III C (2) herein clearly demonstrate that Congress intended that, through the various detailed amendments which the 1950 Revenue Act made which are applicable to Appellant's year ended April 30, 1952, the same tax rule would be produced for that and subsequent years as Section 302(a) did for Appellant's year ended April 30, 1951. It is this clear Congressional intent which governs the instant case and which requires that the judgment of the lower court be reversed.

Respectfully submitted,

Gibson, Dunn & Crutcher,

Attorneys for Appellant.

APPENDIX A.

Section 101 (relevant portions, as amended by the Revenue Act of 1950 and applicable to Appellant's fiscal year ended April 30, 1952):

> "Except as provided in paragraph (12)(b) and in supplement U, the following organizations shall be exempt from taxation under this chapter—
>
> "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholders or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances see sections 3813 and 3814.
>
> "An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term 'trade or business' shall not include the rental by an organization of its real property (including personal property leased with the real property.)
>
> "Notwithstanding paragraph (12)(B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be

considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes."

Supplement U (*Extracts of Relevant Portions*):

IRC Section 421:

"(a) In General.—There shall be levied, collected, and paid for each taxable year beginning after December 31, 1950—

"(1) upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b)(1), a normal tax of 25 per centum of the supplement U net income, and a surtax of 22 per centum of the amount of the supplement U net income in excess of $25,000; except that (A) in the case of taxable years beginning before April 1, 1951, and ending after March 31, 1951, the normal tax shall be 28¾ per centum of the Supplement U net income, and (B) in the case of taxable years beginning after March 31, 1951, and before April 1, 1954, the normal tax shall be 30 per centum of the Supplement U net income.

* * * * * * * *

"(c) Definition of Supplement U Net Income.—The term 'supplement U net income' of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000."

IRC Section 422:

"(a) Definition.—The term 'unrelated business net income' means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business, subject to the following exceptions, additions, and limitations:

"(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

* * * * * * * *

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. This paragraph shall not apply with respect to the cutting of timber which is considered, upon the application of section 117(k)(1), as a sale or exchange of such timber.

* * * * * * * *

"(b) Unrelated Trade or Business.—The term 'unrelated trade or business' means in the case of any organization subject to the tax imposed by section 421(a), any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101 (or, in the case of an organization described in section 421(b)(1)(B), to the exercise or performance of any purpose or function described in section

101(6)), except that such term shall not include any trade or business—

"(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

"(2) which is carried on, in the case of an organization described in section 101(6) or in the case of a college or university described in section 421 (b)(1)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or

"(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions."

Section 3813:

"(b) Prohibited Transactions.—For the purposes of this section, the term 'prohibited transaction' means any transaction in which an organization subject to the provisions of this section—

"(1) lends any part of its income or corpus without the receipt of adequate security and a reasonable rate of interest, to;

"(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered to;

"(3) makes any part of its services available on a preferential basis to;

"(4) makes any substantial purchase of securities, or any other property, for more than adequate consideration in money or money's worth, from;

"(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

"(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

"the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 24 (b)(2)(D)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation.

"(c) Denial of Exemption to Organizations Engaged in Prohibited Transactions.—

"(1) General Rule.—No organization subject to the provisions of this section which has engaged in a prohibited transaction after July 1, 1950 shall be exempt from taxation under section 101(6).

"(2) Taxable Years Affected.—An organization shall be denied exemption from taxation under section 101(6) by reason of paragraph (1) only for taxable years subsequent to the taxable year during which it is notified by the Secretary that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization."

Section 3814:

"In the case of any organization described in section 101(6) to which section 3813 is applicable, if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

"(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101(6); or

"(2) are used to a substantial degree for purposes or functions other than those constituting the basis for such organization's exemption under section 101(6); or

"(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101(6),

"exemption under section 101(6) shall be denied for the taxable year."